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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1059

KERN COUNTY LAND COMPANY,
Petitioner,

v.

OCCIDENTAL PETROLEUM CORPORATION,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER KERN COUNTY LAND COMPANY

DAVID R. HYDE,
Attorney for Petitioner,
80 Pine Street,
New York, New York 10005

Of Counsel:
CAHILL, GORDON, SONNETT,
REINDEL & OHL
F. ARNOLD DAUM
WILLIAM E. HEGARTY
IMMANUEL KOHN
80 Pine Street
New York, New York 10005

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BRIEF FOR PETITIONER KERN COUNTY LAND COMPANY

Opinions Below

The decision of the court of appeals under review is reported at 450 F.2d 157 (1A)*. It reversed the decision of the district court reported at 323 F.Supp. 570 granting summary judgment in favor of petitioner in the amount of $23,511,337.94 (1C).

* Citations with the suffix "A", "B" or "C" are to pages of the Appendix to the Petition for Writ of Certiorari. Citations with the suffix "a" are to pages of the printed Appendix hereto.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit was entered on October 13, 1971 (1B). A petition for rehearing or, in the alternative, rehearing in banc was filed on October 27, 1971. Such petition was denied on November 19, 1971 with Judge Hays noting his dissent from the denial of rehearing in banc (3B, 4B). The petition for a writ of certiorari was filed on February 17, 1972 and was granted on April 17, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Statutory Provisions Involved

Section 3(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a), provides in pertinent part:

> "When used in this chapter, unless the context otherwise requires—
>
> • • •
>
> "14. The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), provides in pertinent part:

> "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner,* director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other

* The term "such beneficial owner" relates back to Section 16(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(a), which provides for the reporting of beneficial ownership of equity securities and changes in such ownership by, among others, "[e]very person who is directly or indirectly the beneficial owner of more than 10 percentum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12" of the Securities Exchange Act of 1934, 15 U.S.C. 78*l*. The securities involved in this action were so registered.

than an exempted security) within any period of less than six months * * * shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. * * * This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

Questions Presented

1. Whether a statutory insider's sale of an option with respect to more than 20% of a class of equity securities, within a month after it had purchased such securities, is a "sale" of such securities under Section 16(b) of the Securities Exchange Act of 1934?

2. Whether a statutory insider's exchange of more than 20% of a class of equity securities for securities of an entirely different company, less than six months after it had purchased such securities in a cash tender offer, is a "sale" of such securities under Section 16(b) of the Securities Exchange Act of 1934?

Statement of the Case

This action was brought by petitioner Kern County Land Company ("New Kern") pursuant to the provisions of Section 16(b) of the Securities Exchange Act of 1934 to recover short-swing profits of some $18 million made by respondent Occidental Petroleum Corporation ("Occident-

al"), in the purchase and disposition of a more than 20% interest in the common stock of petitioner's predecessor-assignor of the same name, the former Kern County Land Company ("Old Kern").

Petitioner submits that the material facts requiring imposition of Section 16(b) liability upon Occidental are undisputed.

Occidental's Purchase of Old Kern Shares

On Monday, May 8, 1967, Occidental publicly announced that it was making a cash tender offer to purchase up to 500,000 shares (an amount in excess of 10% of those outstanding) of Old Kern common stock at $83.50 per share plus a $1.50 commission to brokers who procured tenders. By May 10, 1967, two days after Occidental's tender offer was first announced, more than 500,000 shares of Old Kern stock had been tendered to Occidental (118a-1, 380a), and on May 11, 1967 Occidental announced an amendment of its tender offer to cover an additional 500,000 shares (383a). Prior to the close of its offer on June 8, 1967, Occidental purchased a total of 885,649 shares as a result thereof (20.5% of those outstanding) at a total cost of $75,280,165 (75a-76a, 21C).

The Tenneco-Old Kern Agreement

Following Occidental's announcement of its tender offer, Old Kern's management entered into discussions with various companies, including Tenneco Inc. ("Tenneco") and Occidental itself, with a view to possible corporate combination (263a). On May 19, 1967, Old Kern's Board of Directors approved an offer by Tenneco under which Tenneco was to acquire Old Kern's business and assets in exchange for shares of a new Tenneco Convertible Preference Stock to be distributed to Old Kern shareholders in

liquidation, in exchange for their Old Kern common stock. Old Kern's acceptance of the Tenneco offer was announced the same day (259a-267a).

Occidental appraised the Tenneco Convertible Preference Stock at $105 per share and its President, Dr. Armand Hammer, issued a statement dated the same day, Friday, May 19, 1967, to Occidental stockholders announcing an indicated "profit to your company of about $18 million . . ." as a result of the Tenneco offer (328a, pp. 6-7).

The Occidental Option Agreement

Nevertheless, on the following Monday, May 22, 1967, Occidental made written demand upon Old Kern for an inspection of its list of shareholders, books of account, minutes of stockholder, board of directors and executive committee meetings, together with all records, books and documents referred to therein (286a). On Thursday, May 25, 1967, Occidental filed a petition in the California Superior Court demanding inspection of such documents (465a).

Prior to the return date of its petition, Occidental, describing itself as "the principal stockholder of Kern County Land Company", made a further written demand upon Old Kern calling for inspection of numerous additional books and records, as well as "the election of at least two (2) persons to be designated by Occidental to the board of directors" (289a). This demand was followed by the filing of a second court petition on May 31, 1967, alleging Occidental's status as owner of more than 10% of Old Kern's common stock and asserting that it needed such inspection in order to determine whether or not "to oppose" the Tenneco-Old Kern transaction, citing the time needed "to prepare proxy soliciting material" and to "file preliminary copies of such proxy soliciting material with the Securities and Exchange Commission" (474a, 477a). Prior to any court ruling on

Occidental's petitions, Old Kern voluntarily permitted an Occidental team of up to five lawyers and accountants to inspect such non-public documents as Old Kern's general ledger, consolidating financial statements, consolidating journal entries, details of cash receipts from oil operations, supporting trial balances and other records over a six-day period (268a).

In the interim, on May 23, 1967 (the very day after Occidental had first demanded inspection of Old Kern's records), Occidental's Executive Vice President, Mr. Walter R. Davis, requested a meeting with Mr. Gardiner Symonds, then Chairman of the Board and chief executive officer of Tenneco (252a). Such meeting could not be arranged until May 30, 1967, the Memorial Day holiday, at Mr. Symonds' home in Houston, Texas. Then, according to Mr. Davis' deposition testimony:

> "I went in and after just miscellaneous conversation, I told Mr. Symonds that I felt like Occidental did not want to get into a proxy fight with Tenneco or a fight in the Kern County situation and that I had been authorized by Dr. Hammer to discuss with him the possible purchase of our stock * * *" (45a).

Nevertheless, as noted above, on the very next day, May 31, 1967, Occidental filed its second court petition in San Francisco, making reference to the preparation of proxy soliciting material.

The initial meeting between Mr. Davis and Mr. Symonds was followed by meetings between them in New York on June 1 and June 2, 1967, at which the parties were also represented by counsel. At these meetings, Occidental's attorneys proposed, instead of the outright sale originally proposed by Occidental, that the parties enter into an option agreement exercisable after December 9, 1967 (six months

plus one day after the closing date of Occidental's tender offer), giving Tenneco an option to purchase at $105 per share 886,623 shares of Tenneco Preference Stock which Occidental would receive in exchange for its Old Kern common stock upon consummation of the Tenneco-Old Kern agreement (253a). The cost of this option was to be $10 per share, or a total of $8,866,230 to be credited against the aggregate purchase price of $93,095,415 upon exercise of the option. This was agreed to by Tenneco and a formal written option agreement between Occidental and Tenneco Corporation (a subsidiary of Tenneco Inc.) was prepared. It provided that, if the closing of the Tenneco-Old Kern agreement did occur, Occidental would retain the $8,866,230 which it had received even though Tenneco failed to exercise its option (129a, *et seq.*).

On Friday, June 2, 1967, the Option Agreement was executed on behalf of Tenneco and Occidental. On the same day, Occidental publicly announced that it would not oppose Tenneco's proposed acquisition of Old Kern (330a-331a), and gave its attorney, Mr. Albert J. Brown, of the San Francisco firm of Pillsbury, Madison & Sutro, a proxy to vote its Old Kern shares specifically authorizing him "to vote in favor of the proposed sale of the assets of Kern County Land Company to a wholly-owned subsidiary of Tenneco Inc." Mr. Brown in turn assured Tenneco's counsel that he would vote Occidental's Old Kern shares in favor of the Tenneco acquisition.* Occidental also thereafter voluntarily dismissed its pending legal actions for production

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* The foregoing proxy and Mr. Brown's assurances were not part of the record before the district court and the court of appeals, but were brought to the court of appeals' attention by the petition for rehearing (506a, *et seq.*) which pointed out that discovery below had not been completed and that there were additional facts concerning the option which could be elicited at a trial. Petitioner contended that, given the existence of such facts, the court should not have granted summary judgment in favor of Occidental on the ground, *inter alia*, that the option was not "in truth and fact a sale."

of Old Kern books and records (318a, 327a), and abandoned its demand for representation on Old Kern's Board.

Upon the execution of the Option Agreement on June 2, 1967, Tenneco paid Occidental $886,623 by check and a week later transmitted the rest of the total $8,866,230 option price (85a).

Subsequently, Mr. Brown asked to be relieved of his undertaking to vote the proxy Occidental had given him in favor of the Tenneco transaction. This was consented to by Tenneco only when it became apparent that Occidental's vote was not needed to provide the 50% affirmative vote necessary to approve Tenneco's acquisition of Old Kern.* Instead, it was agreed that Occidental would submit a letter, to be read at the Old Kern stockholders' meeting, which stated that Occidental was not voting because "we would rather have worked out our own transaction with KCL [Old Kern]" but that it did not "view the transaction as unfair or inequitable to a KCL shareholder", and that if "the transaction were one in which we had a right of appraisal, we would not seek such right but would vote in favor of the sale of assets" (127a).

Occidental's Efforts to Secure an SEC Rule

On the Monday following execution of the Option Agreement, June 5, 1967, Occidental's counsel sent Tenneco's counsel a copy of a proposed Rule 16(b)-11 which Occidental had asked the Securities and Exchange Commission to adopt (102a, 180a). This proposed rule would have exempted from the provisions of Section 16(b) the "disposition . . . pursuant to a merger or consolidation" of securities by a beneficial owner of more than 10%, provided the beneficial owner (a) had acquired them in a public tender

* This matter was also brought to the attention of the court of appeals by the petition for rehearing (510a-511a).

offer and (b) continued to hold the security acquired by him in the merger more than six months after his purchase of the original security (180a). The next day, June 6, 1967, Occidental's counsel wrote to Tenneco's counsel concerning the proposed rule (239a-240a). Counsel's letter referred to a telephone conversation had the previous day with Mr. Philip Loomis, then General Counsel of the Securities and Exchange Commission, "to discuss the proposed rule that the SEC was considering to give Occidental some relief in the situation in which it found itself". The letter stated:

> "As we had proposed the rule and, as we had understood from Myer Feldman [Occidental's Washington counsel], we were going to be granted an exemption at both ends."*

The letter further noted that if a rule were not adopted, the "only alternative" Occidental would have would be "to commence every kind of litigation it could reasonably bring and attempt to stall the consummation of the Tenneco-Kern transaction for six months", and that "[o]bviously this would be disadvantageous to the other Kern stockholders".**

On July 12, 1967, the Commission advised Occidental's counsel that "the Commission considers it undesirable to

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* The phrase "both ends" reflects Occidental's then concern about the possibility that its acquisition of Tenneco Preference Stock coupled with its disposition of such stock upon exercise of the Option Agreement might give rise to a separate Section 16(b) liability. This potential liability, which did not ultimately arise, is discussed in footnote 6 of the opinion below (5A).

** A whole series of purported stockholder suits attempting to block the Tenneco-Old Kern transaction did subsequently materialize. These are reviewed in detail in the opinion of the District Court for the Northern District of Texas in *600 California Corp.* v. *Harjean Co.*, 284 F.Supp. 843 (N.D. Tex. 1968), in which the court concluded that "somebody with a lot more at stake and a much stronger motive for delaying the closing than these named plaintiffs was furnishing an almost unlimited expense account to finance this weird pattern of delaying actions" (284 F. Supp. at 861).

publish for comment any proposed rule in this area at the present time" (191a). Occidental persisted in its efforts to obtain a rule from the Commission and on August 29, 1967 the full Commission heard argument in support of a modified and more restricted version of Occidental's proposed rule (104a, 199a), and later considered a 30-page letter from Occidental's counsel in further support of its proposed rule (202a). Nevertheless, the Commission refused to modify its earlier decision not to take action and no such rule was ever adopted.

The Closing of the Tenneco-Old Kern Transaction

Tenneco's acquisition of the business and assets of Old Kern was embodied in a formal Agreement and Plan of Reorganization between Tenneco, Old Kern and petitioner (a newly organized Delaware corporation formed by Tenneco to acquire the business and assets of Old Kern) (124a). This Agreement, which provided for the liquidation of Old Kern and the exchange of Tenneco Preference Stock for Old Kern common stock by Old Kern shareholders, was approved by the Old Kern shareholders at a meeting held on July 17, 1967, at which time Occidental caused its letter setting forth its lack of opposition to the transaction to be read to the shareholders (269a-270a).

On August 30, 1967, the closing of the Tenneco-Old Kern agreement was held. Old Kern transferred its assets and business to petitioner and received shares of Tenneco Preference Stock, which it deposited with the Exchange Agent with irrevocable instructions for distribution of such shares to the Old Kern shareholders upon receipt of their Old Kern stock certificates for cancellation (153a). Thereupon (less than four months after Occidental had acquired its shares), Old Kern's stockholders, including Occidental, ceased to own any interest in Old Kern as an independent operating company, and their Old Kern stock certificates became evidence only of their beneficial ownership of shares of Tenneco Preference Stock (79a-80a). On October

6, 1967, Old Kern was formally dissolved pursuant to California law (82a-83a).

On December 11, 1967, a closing was held under the Option Agreement in Nassau, Bahamas, at which time $84,229,185 was credited to Occidental's accounts at various banks. With this amount, plus the $8,866,230 which had been paid to it in June, Occidental received $93,095,415 with respect to its Old Kern stock (21C). With respect to the 885,649 shares purchased pursuant to its tender offer, this represented a $17,712,980 profit (22C). In addition, Occidental received two dividends totaling $1,793,439.22 with respect to such shares (25C), which, when added to the $17,712,980 profit realized on Occidental's sale of stock, come to a total profit of $19,506,419.22 realized by Occidental by reason of its acquisition and disposition of its 20% beneficial interest in Old Kern common stock.

The Proceedings Below

On October 17, 1967, following the institution of two actions on behalf of Old Kern stockholders, petitioner, as assignee of Old Kern, filed this action pursuant to Section 16(b) for recovery by it of Occidental's short-swing profits. These actions, and a third Old Kern stockholder action subsequently instituted, were consolidated for purposes of pre-trial discovery (44 F.R.D. 543, S.D.N.Y. 1968).

Following certain limited discovery directed to establishing grounds for a motion for summary judgment by plaintiffs, petitioner and the other plaintiffs moved for summary judgment on the basis of the undisputed facts elicited thus far. In an opinion filed on November 27, 1970, Judge Edmund L. Palmieri granted petitioner's motion holding Occidental liable to petitioner for profits of $17,712,980, that being the profit realized by Occidental at $20 per share on the 885,649 shares acquired by it through its tender offer.

Interest at 6% was awarded on the above amount from the dates the monies were received by Occidental. The court found that a "sale" within the meaning of Section 16(b) had occurred *both* by reason of the June 2, 1967 option agreement and by reason of the August 30, 1967 exchange of Old Kern shares for Tenneco shares, either of which had resulted in a short-swing profit to Occidental of $20 per share of Old Kern stock.

Subsequently, the court filed a supplemental opinion awarding petitioner an additional $1,793,439.22, the total amount of the dividends received by Occidental, with interest at 6% from the dates of receipt (25C). Judgment was entered on February 18, 1971 in the total amount of $23,511,337.94 (503a-504a).

On appeal to the Court of Appeals for the Second Circuit, the court reversed Judge Palmieri's entry of summary judgment in favor of petitioner, holding that neither the option agreement nor the exchange of Old Kern for Tenneco shares constituted a "sale". The court further directed summary judgment in favor of defendant Occidental although such relief had not been sought by it in the district court (16A-17A).*

In view of its disposition of the matter, the court did not find it necessary to pass on various issues raised by Occidental on its appeal, including its contention that only those shares tendered to it after it had been tendered 10% of the Old Kern shares outstanding should be the subject

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* Occidental asked the district court "to deny plaintiffs' motions for summary judgment pending a full trial on the merits" (337a). On its appeal, Occidental asserted in one sentence of its 122-page brief that the district court "should have granted summary judgment to Occidental or proceeded to trial on the merits", noting in a footnote that the court had power to grant judgment in its favor despite Occidental's failure to move for such relief. The point was not pressed and petitioner made no response to it since it did not appear to be seriously urged.

of a 16(b) recovery,* and its objection to the award of prejudgment interest and dividends.

Summary of Argument

The decision of the court of appeals below ignores the "mechanical quality" of Section 16(b) recently noted and applied by this court in *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U. S. 418 (1972), and instead, follows an *ad hoc* approach throughout confining itself to particular facts of the particular case. So doing, the court construes the statutory term "sale" narrowly so as to exclude not only Occidental's sale of an option but also the subsequent exchange of Old Kern shares for Tenneco shares. Both of these events occurred less than four months after Occidental purchased over 20% of Old Kern's common stock.

1. First, in holding that an insider's short-swing sale of an option is not a "sale" (despite its acknowledgment that such an option falls within the statutory definition of "sale"), the court of appeals failed to follow long-

* The district court held that Occidental's initial tender offer "constituted a single act of Occidental, whereby the company became a beneficial owner of 10 per cent of Old Kern's capital stock" (18C). Such a purchase has been held to be one making the purchaser a 10 per cent beneficial owner "at the time of the purchase", within the language of Section 16(b), thus bringing the entire transaction (not just the amount in excess of 10% of the issuer's stock) within the scope of Section 16(b). *Stella* v. *Graham-Paige Motors Corp.*, 232 F.2d 299, 300 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956); *Newmark* v. *RKO General, Inc.*, 425 F.2d 348, 355-56 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970). This rule was also applied by the court of appeals in *Emerson Electric Co.* v. *Reliance Electric Co.*, 434 F.2d 918. 924 (8th Cir. 1970), *aff'd*, 404 U.S. 418 (1972), which affirmed the district court holding that a purchase of stock falls within Section 16(b) where the purchaser becomes a 10% owner by virtue of the purchase, in that case (as here) by virtue of a public tender offer. Emerson did not cross-petition for certiorari as to this holding. See 404 U.S. 418, 421.

established criteria for the construction of Section 16(b). An insider is conclusively presumed to have access to inside information not available to other stockholders. In entering into transactions in his company's securities, including the sale of an option, his access to inside information gives him an *opportunity* to profit not enjoyed by other stockholders. Both common sense and the statutory presumption upon which Section 16(b) is premised compel the conclusion that an insider who sells an option is far more likely to profit by such transaction than he is to suffer a loss. Since an *opportunity* for speculative profit is presented, the insider's sale of an option must be held a "sale" for purposes of Section 16(b) liability.

Moreover, assuming *arguendo*, as the court of appeals held, that an option must be shown from the "economic realities" of the particular case to be "in truth and fact a sale", to come within Section 16(b), the Occidental option in issue must be held to be such a transaction. The nearly $9 million paid for the option, Occidental's giving of a proxy simultaneously with its execution of the option agreement, and Occidental's abandonment of its pending demands for representation on Old Kern's board and for production of Old Kern's records make the Occidental option tantamount to an outright sale.

2. Secondly, the court of appeals further erred in holding that, on the particular facts presented, the exchange of Old Kern securities for Tenneco securities was not a "sale" under Section 16(b) (the first occasion on which any court has held that an exchange of securities of one company for those of another company did not constitute a "sale" under Section 16(b)). Here again, the court ignored the "mechanical quality" of the statute and made an *ad hoc* evaluation of what it considered the "equities" of the particular case.

Petitioner maintains that an insider's exchange of the securities of one company for those of a totally different

company, regardless of what may have precipitated such exchange, presents an opportunity for speculative profit and must be deemed within the coverage of Section 16(b) if the purposes of that section are to be given full force and effect.

Moreover, here the court of appeals in effect adopted a rule with respect to tender offerors which the Securities and Exchange Commission, the body given responsibility for adopting exemptive rules under Section 16(b), and which has adopted rules exempting certain non-cash exchanges from the operation of Section 16(b), refused to adopt at Occidental's behest.

I.

The Occidental Option Was A "Sale" Under Section 16(b).

As a Matter of Law, the Option was a Sale

Although "recognizing that, under the statutory definition, § 3(a)(14) [of the 1934 Act], 'sale' includes 'contract to sell'" and that "an option entitling the optionee to purchase is a contract to sell in a dictionary sense", the court of appeals nevertheless held that an insider's "mere grant of an option to purchase is not a sale for purposes of § 16(b)" and that an insider's sale "occurs only when the optionee exercises the option" (13A). It is implicit in such holding that if the option for any reason goes unexercised, the transaction is immune from Section 16(b) liability regardless of what profit the insider may have realized upon the sale of the option.

In formulating such a rule, the court of appeals did not undertake any examination of the speculative possibilities inherent in an insider's short-swing sale of an option but merely cited its own prior decision in *Silverman* v. *Landa*,

306 F.2d 422 (2d Cir. 1962). There the defendant had engaged in a "straddle", *i.e.*, the simultaneous sale of matching put and call options, which the plaintiff attempted to characterize as a purchase and a sale within six months. There was no question there (as is the fact here) of any underlying securities having been acquired by the insider within the prior six months. The court appears to have regarded this "straddle" as an unlikely device for speculative abuse, holding (over the objections of the Securities and Exchange Commission as amicus curiae*), that neither a purchase or sale had occurred and that:

> "Merely because the options may have been entered into for a speculative purpose, it does not follow that they constitute purchases and sales of the type which were penalized." (306 F.2d at 425)

The reasoning of the court of appeals expressed in *Silverman* v. *Landa, supra,* and applied by the court below (despite its recognition that the Occidental option fell within the statutory definition of sale) to the totally different transaction presented here is at variance with long established criteria for the construction of Section 16(b). As Mr. Justice Stewart, while on the court of appeals, noted:

> "Every transaction which can reasonably be defined as a purchase will be so defined if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b)." *Ferraiolo* v. *Newman,* 259 F.2d 342, 345 (6th Cir. 1958), *cert. denied,* 359 U. S. 927 (1959).

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* The Commission argued that "the very same factors that led this court to determine in *Blau* v. *Ogsbury* [210 F.2d 426 (2d Cir. 1954)], that the date of exercise of an option is controlling when an insider is a *purchaser* require a determination that the date of issuance is controlling when an insider is the *issuer* of the option". (Emphasis the Commission's) (Brief for Securities and Exchange Commission as Amicus Curiae, p. 19)

Again, in *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418 (1972), this court recently held:

> "[W]here alternative constructions of the terms of § 16(b) are possible, those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders." (404 U.S. at 424)
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> "In interpreting the terms 'purchase' and 'sale', courts have properly asked whether the particular type of transaction involved is one that gives rise to speculative abuse. See, *e.g.*, *Bershad* v. *McDonough*, 428 F.2d 693 [7th Cir. 1970] (granting of an option to purchase constitutes a 'sale')". (404 U.S. at 424, n. 4)

If (despite the statutory definition of "sale" set forth in Section 3(a)(14) of the Act) an insider's short-swing sale of an option can be considered a type of transaction "where alternative constructions of the terms of § 16(b) are possible", it is clear that the option device is a "type of transaction . . . that gives rise to speculative abuse". In contrast to the decision of the court of appeals here, which held, without discussing the possibilities for speculative abuse, that the "mere grant of an option to purchase is not a sale for purposes of § 16(b)" and that a sale occurs "only when [and if] the optionee exercises the option" (13A), the Court of Appeals for the Seventh Circuit in *Bershad* v. *McDonough*, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971), analyzed the speculative possibilities inherent in an insider's sale of an option and concluded:

> "The insider's sale of options in his stock is *well adapted to speculation and abuse* of inside information *whether or not the option is subsequently exercised*. The sale of the right to purchase the underlying security is itself a means of realizing a profit from that security. The right to purchase stock at a given price under specified circumstances, although

> clearly not identical to the rights attendant upon ownership of the stock itself, derives from and is dependent upon the value of the underlying security. *Sale of such purchase rights provides an easy vehicle for the use of inside information in extracting profits from the stock itself.*" (Emphasis added) (428 F.2d at 698)

Petitioner submits that the decision of the Seventh Circuit in *Bershad* v. *McDonough*, which was cited and quoted with approval in both the majority and dissenting opinions of this Court in the *Reliance* case, rather than the decision of the Second Circuit Court of Appeals here, sets forth the correct interpretation of Section 16(b).

In determining whether or not an insider's short-swing sale of an option is the kind of transaction "which can possibly lend itself to the speculation encompassed by Section 16(b)" (*Ferraiolo* v. *Newman, supra*), we start with the conclusive statutory presumption that the insider has access to inside information. As Judge Learned Hand observed, in one of the earliest decisions interpreting Section 16(b):

> "If only those persons were liable, who could be proved to have a bargaining advantage, the execution of the statute would be so encumbered as to defeat its whole purpose." *Gratz* v. *Claughton*, 187 F.2d 46, 50 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951).

And, as the Court of Appeals for the Eighth Circuit recently held in the *Reliance* case:

> "The intent as to such short-swing transactions was to stop the *possible*, not the actual—for that was considered to be too difficult to prove—use of inside information. It is clear that Section 16(b) applies to every more than 10 percentum beneficial owner without regard to his factual access to or possession of inside information." (Emphasis by the Court) (footnote omitted) *Emerson Electric Co.* v. *Reliance*

Electric Co., 434 F.2d 918, 923-24 (8th Cir. 1970), *aff'd*, 404 U.S. 424 (1972).*

Logic and common sense dictate that one armed with inside information can use such information to his advantage in selling an option. In the first place, he can use such information to determine whether or not to enter into such a transaction, or with respect to the timing of the transaction, doing so only if and when such a course of action appears advantageous to him. Secondly, when he determines that such course of action is advantageous, his presumed access to inside information can enable him to fix a price and terms most likely to maximize his profits. For example, on December 11, 1967, the date the Occidental option was exercised, the Tenneco Preference Stock traded in the over-the-counter market at 93½ bid, 95½ asked (Wall Street Journal, December 12, 1967). Instead of the $8.50 to $10.50 per share profit Occidental would have received had it waited until then to dispose of its Old Kern holdings (letting the six-month statutory period elapse), Occidental in fact received a total of $20.00 per share, or at least an additional $8.4 million, by reason of having entered into the Option Agreement on June 2, 1967, well within the statutory period.

As noted above, in contrast to the Seventh Circuit in *Bershad* v. *McDonough*, the court of appeals here did not

* The *Reliance* case also involved the acquisition by tender offer of stock of an admittedly hostile issuer. There was no evidence that the offeror, Emerson, had actual access to inside information. In fact, litigation was instituted by the target company, Dodge, to enjoin the tender offer. The District Court for the Northern District of Indiana refused injunctive relief finding that Emerson did not have any "insider" information about Dodge and that all its knowledge had been obtained from public sources. Emerson was also denied access to the Dodge stockholder list and had to file suit to obtain it. (434 F.2d 920, fns. 5, 6). Here, Occidental had an extensive examination of Old Kern's non-public records by a five-man team of lawyers and accountants extending over a six-day period (see, *supra*, pp. 5-6).

discuss in any way the speculative possibilities inherent in an insider's short-swing purchase of stock followed by the sale of an option with respect to that stock. Instead, making an *ad hoc* appraisal of the Occidental option, the court of appeals (ignoring Occidental's contemporaneous threats of a proxy fight) accepted Occidental's contentions that the option price was "a reasonable, non-coercive price" (14A), and the Option Agreement itself "a straight-forward business arrangement" (16A).* Consequently, the court of appeals held Occidental's option to be outside the scope of Section 16(b).

Occidental's threats of a proxy fight aside, the idea that 16(b) liability turns in any way upon the question of whether the sales price received by the defendant is "reasonable" or the transaction a "straight-forward" one is novel, to say the least. If a "reasonable" price or a "straight-forward business arrangement" were enough to avoid Section 16(b) liability, any sale on a stock exchange, for example, would be exempted. Suffice it to say that the statute expressly provides for the recovery of "any profit realized", not just excess profits, or profits of dubious origin.

Secondly, the court of appeals, accepting Occidental's argument that the option agreement did not guarantee it a "sure-thing profit", recited ways in which it believed the option agreement might have redounded to Occidental's disadvantage (although in actual fact it proved highly profitable). Thus, the court noted that the option price might have to be refunded if the Tenneco-Old Kern agreement did not close (a possibility that was eliminated well before the expiration of the Section 16(b) six-month period),** that

* As discussed more fully below, pp. 24-25, petitioner did not contend that the option was a sham, but that the terms and conditions of the option were such as to compel exercise of it, making it tantamount to a conventional sale.

** The Tenneco-Old Kern closing was held on August 30, 1967. At that time (less than four months after Occidental had acquired its stock) Occidental became absolutely entitled to retain the $9 million option price.

the option might have gone unexercised "if the bottom had fallen out of the market" (in which case Occidental would still have retained the $9 million option price) or that "the option might have proved disadvantageous to Occidental if the Tenneco stock had boomed or if someone desiring to make a target of Tenneco had come forward with an offer to Occidental." (16A) (*i.e.*, Occidental would conceivably have been able to make even greater profits if it had retained absolute ownership of its Old Kern stock instead of optioning it—a possibility which is also present whenever any insider sells his stock outright for cash instead of retaining it).

The court of appeals' view that the option agreement might, under certain hypothetical circumstances which did not occur, have proved disadvantageous to Occidental, provides no justification for allowing Occidental to retain profits in fact realized. It is well established that a defendant may not offset his short-swing trading losses against his profits. In *Gratz* v. *Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U. S. 920 (1951), Judge Learned Hand "affirmed a judgment of $300,000 against the insider defendant although, during the pertinent periods, he suffered a net loss of $400,000 on trading in the stock for which he was charged under Section 16(b)." *Adler* v. *Klawans*, 267 F.2d 840, 847 (2d Cir. 1959). Given such an uncompromising rule, it would be incongruous in the extreme to permit a defendant who has sustained no losses whatever to show a mere *possibility* of losses or some other potential disadvantage (which we submit was non-existent here) as an excuse for retaining profits *actually* realized. The *possibility* that the insider's speculation may on rare occasions boomerang is no reason for permitting him to keep the fruits of his speculation in the overwhelming number of instances where, as is to be expected, it proves, in fact, to be profitable. Section 16(b) is a remedial statute designed "to squeeze all *possible profits* out of stock transactions" by insiders. *Smolowe* v.

Delendo Corp., 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U. S. 751 (1943) (emphasis added).

Whatever may be said as to the alleged involuntariness of Occidental's subsequent exchange of Old Kern shares for those of Tenneco, there is no gain-saying the fact that Occidental's entry into the Option Agreement was an entirely voluntary, purposeful act on its part. Less than one month after its purchase of better than 20% of Old Kern's common stock, Occidental sought out Tenneco and, mentioning in the same breath a possible proxy fight against Tenneco (*supra*, p. 6), proposed first an outright sale of its stock and then switched to the sale of an option with respect to such stock, on terms that would give it a profit of nearly $18 million if the option were exercised, and nearly $9 million even if it were not. In return for the Option Agreement Occidental received an immediate cash-in-hand payment of nearly $9 million less than one month after it had purchased the stock in question. Ultimately, it realized a total profit of nearly $18 million, exclusive of dividends and interest. Petitioner submits that recovery of this $18 million profit is clearly within both the language and the purpose of the statute.*

In "Truth and Fact" the Option was a Sale

Although refusing to hold that the sale of an option, *qua option*, is a sale for Section 16(b) purposes, the court of

* The fact that the option was not exercised until after the six-month statutory period had passed should make no difference when it comes to recovery of the total profit. The fact that a final cash payment is not received until after the six months have passed is irrelevant when the transaction that results in such profit is entered into within the statutory period. *Blau* v. *Allen*, 163 F. Supp. 702 (S.D.N.Y. 1958). Otherwise, the insider could structure the transaction in a way which would defer receipt of all or most of his profits until the six months had elapsed. Thus, in *Bershad* v. *McDonough*, *supra*, judgment was entered for the total profit realized, $612,000, although only the option premium, $350,000, had been received within the six-month period.

appeals acknowledged that under certain circumstances a court might "look through the form of an option to the economic realities" and "find that in truth and fact a sale had occurred when the 'option' was granted" (13A-14A). This approach, which would impose liability only when the option is a conventional, outright sale in disguise, would not only exempt many insider options (with their profits) from Section 16(b) liability, but would require an *ad hoc* disposition of each option case. The necessity for a factual determination of whether a given option was a *bona fide* option or was one "accompanied by a wink of the eye", to use the language of the court below (15A), would necessarily require "a judicial search for the will-o'-the-wisp of an investor's 'intent' in each litigated case" and inevitably undermine the "mechanical quality" of the statute in this important area. *Cf., Reliance Electric Co.* v. *Emerson Electric Co., supra,* 418 U.S. at 425.

However, even if the court of appeals were correct in holding that only an option which is somehow "in truth and fact a sale" (14A) can be deemed a "sale" for purposes of Section 16(b), the Occidental option meets that test. Again, *Bershad* v. *McDonough, supra,* where the court was able to find, as an additional reason for affirming the judgment below, that the stock in question was "effectively transferred, for all practical purposes, long before the exercise of the option" (428 F.2d at 698), is instructive.

In the *Bershad* case, the defendants purchased approximately 18% of the outstanding shares of Cudahy Company common stock on March 15 and 16, 1967 at $6.75 per share. Some four months later defendants entered into an option agreement under which they were obligated to sell the bulk of these shares at $9 per share on or before October 1, 1967; the optionee paid $350,000 (14% of the purchase price) for the option to be applied against the purchase price in the event of exercise and, in the event of non-exercise, to be

retained by the defendants. At the same time, the defendants gave the purchaser a proxy with respect to the optioned stock, irrevocable until October 1, 1967. Defendant McDonough and his colleagues then resigned as Cudahy directors in favor of nominees of the option purchaser. The purchaser indicated its intention to exercise the option on September 22, 1967, six months and six days after defendants' purchase, and the shares were delivered five days later. On these facts the Seventh Circuit Court of Appeals, affirming a grant of summary judgment to plaintiff, concluded that "the stock was effectively transferred, for all practical purposes, long before the exercise of the option" (428 F.2d at 698).

In the present case, the Occidental option served none of the economic functions which underlie the normal option. It was suggested by Occidental's counsel, in an admitted effort to avoid Section 16(b) liability, only after Occidental had first proposed an immediate outright sale of its Old Kern holdings to Tenneco. The option price amounted to almost $9 million (25 times the amount in *Bershad*), was nearly 10% of the total $93,095,415 purchase price, was to be applied to the purchase price upon exercise of the option, and was to be forfeited if the option were not exercised, leaving little if any realistic possibility of non-exercise.* The execution of the option was also accompanied by the giving of a proxy to Occidental's attorney in which he was "specifically authorized" to vote in favor of Tenneco's acqui-

* As noted above, the court of appeals found a possibility of non-exercise "if the bottom had fallen out of the market" (14A). The same point could, of course, have been made in the *Bershad* case where the optionee was under no legal obligation to take the shares and might well have refused to exercise his option if some unforeseen event had occurred causing the market price of Cudahy shares to plummet. Such a hypothetical contingency did not prevent the Seventh Circuit from finding that "the stock was effectively transferred, for all practical purposes, long before exercise of the option" (428 F.2d at 698).

sition of Old Kern and by his assurance to Tenneco, in turn, that the Occidental proxy would be so voted. Tenneco relieved Occidental's attorney of his undertaking only when it became apparent that Occidental's vote was not needed. (511a) While there was no resignation of directors (Occidental had no representatives on the Old Kern board), Occidental's pending demand for two seats on Old Kern's board was abandoned, as was its pending litigation for inspection of Old Kern's books and records. In short, the Occidental "option" was just as much a sale as of the date it was entered into as the "option" in the *Bershad* case. However, while the Court of Appeals for the Seventh Circuit affirmed a grant of summary judgment *against* the defendants, the court of appeals here directed summary judgment *in favor of* defendant Occidental, although such relief had not even been sought in the district court.

Here, the court of appeals resolved all questions of fact as to the "economic realities" underlying the option in favor of Occidental without trial and without any expert economic testimony having been adduced. For example, the court of appeals' opinion, in its treatment of the option, purports to rely upon "undisputed testimony that the forfeitable down payment, 10.05%, was a reasonable, non-coercive price . . ." (14A). The only such testimony was hearsay testimony given in a deposition by Mr. Walter Davis, Occidental's Vice President, in which he recited what someone from the investment firm of Donaldson, Lufkin & Jenrette allegedly told him (363a-364a).

Mr. Davis' testimony was merely to the effect that he had made inquiry as to an appropriate price for a six-month call on a stock selling for $95, the price at which Old Kern stock was then being traded. There was no indication that Donaldson, Lufkin & Jenrette was informed of the magnitude of the block of stock in question nor of the other terms

and conditions (363a-364a). Because petitioner did not believe it necessary to rebut this hearsay testimony in order to prevail upon its motion for summary judgment (and not being faced with a cross-motion for summary judgment in favor of Occidental), the source of that opinion was never deposed. Such hearsay testimony would be of dubious admissibility at trial, but even if admissible should (assuming its relevance) surely be the subject of cross-examination of the source, and is certainly subject to rebuttal by expert testimony.

Consequently, while petitioner respectfully submits that the district court's grant of summary judgment in its favor was clearly correct under either of the holdings in *Bershad* v. *McDonough, supra,* and should have been affirmed by the court of appeals, at the very least the court of appeals should, given its view of the law, have remanded for trial with respect to the question of whether or not "in truth and fact a sale had occurred when the 'option' was granted" (14A), rather than directing summary judgment in favor of Occidental.

II.

Alternatively, The Exchange Of Kern Shares For Those Of Tenneco Was A "Sale" Under Section 16(b).

Apart from its holding with respect to the option, the court of appeals further held that the August 30, 1967 exchange of Old Kern shares for Tenneco shares (which occurred less than four months after Occidental's purchase of its 20% interest in Old Kern) did not constitute a "sale" by Occidental within the meaning of Section 16(b).

Looking to the facts underlying the exchange, the transaction is clearly one that falls within the statutory definition of "sale". On August 30, 1967, Old Kern transferred its business and assets to petitioner, agreed to dissolve and terminate its corporate existence and delivered the Tenneco

Preference Stock received by it to the Exchange Agent, with irrevocable instructions to deliver the Preference Stock to the record owners of Old Kern stock against the surrender of their Old Kern stock certificates (82a, 16C-17C).

Aside from differing income tax consequences, the net effect of the above events was exactly what would have occurred had Occidental made a cash sale of its Old Kern stock and a cash purchase of a like amount of Tenneco Preference Stock. Occidental's record ownership of Old Kern stock ceased to represent an equity investment in Old Kern as an independent operating company and became merely evidence of its "beneficial ownership" within the meaning of Section 16 of an equal number of shares of the Tenneco Preference Stock. *Blau* v. *Mission Corp.*, 212 F. 2d 77, 80 (2d Cir.) *cert. denied*, 347 U. S. 1016 (1954).

Prior to the decision here, a long line of Section 16(b) decisions had established that an exchange of stock of one company for that of another involves a "sale" of the security surrendered and a "purchase" of the security received on which a profit is realized, just as clearly as if there had been a cash sale followed by a purchase made with the proceeds. Such decisions motivated Emerson's sales transactions in *Reliance Electric Co.* v. *Emerson Electric Co., supra.* As this Court noted in its opinion, Emerson, which like Occidental had acquired its stock position in a cash tender offer, had encountered "certain failure" in its efforts to take over Dodge and was faced "with the prospect of *being forced to exchange* its Dodge shares for stock in the merged corporation in the near future" (emphasis added). 404 U. S. at 420. Emerson wanted to "immunize" a portion of those shares from liability under Section 16(b). Its concern about Section 16(b) liability was understandable. As this Court noted in a footnote to its opinion:

> "The Court of Appeals for the Second Circuit has held that an exchange of shares in one corporation

> for those of another pursuant to a merger agreement constitutes a 'sale' within the meaning of § 16(b). *Newmark* v. *RKO General, Inc.*, 425 F. 2d 348, 354 [2d Cir. 1970]." 404 U. S. at 420.

Similarly, *Marquette Cement Mfg. Co.* v. *Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965); *Blau* v. *Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951); and *Gold* v. *Scurlock*, 324 F. Supp. 1211 (E.D. Va. 1971) (appeals pending*), each involved transactions identical in all essentials with the exchange now in issue. In each case, the court found "purchases" of the stock distributed in connection with the sale of the issuer's assets; from this the inference of a "sale" of the stock of the issuer by those receiving the stock so distributed is inescapable.

So also, in actions arising under Section 10(b) of the 1934 Act, an exchange of securities in different companies has been uniformly held to be a "purchase" or "sale" of such securities. *E.g., SEC* v. *National Securities, Inc.*, 393 U. S. 453 (1969) ("shareholders 'purchased' shares in the new company by exchanging them for their old stock"); *Dasho* v. *Susquehanna Corp.* 380 F. 2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977 (1969) ("an acquisition or disposition of securities in exchange for other securities falls within the statutory definitions [Secs. 3(a)(13) and (14)]"); *Vine* v. *Beneficial Finance Co., Inc.*, 374 F. 2d 627 (2d Cir.), *cert. denied*, 389 U. S. 970 (1967).

In reaching a contrary result in this case, the very first time that an exchange of securities in different companies has been construed to be anything other than a "purchase" or "sale" of such securities under the Securities Exchange Act of 1934, the court of appeals expressed its view that to deprive Occidental of the $18 million profit it realized on

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* On May 22, 1972, the Court of Appeals for the Fourth Circuit, noting "with interest" this Court's grant of certiorari in this matter, entered an order deferring final disposition of the appeals until this Court's decision had been rendered.

the exchange would be "repugnant to our sense of equity" (13A). This was the first occasion, so far as we can determine, that that venerable doctrine has been invoked by any court to avoid the imposition of Section 16(b) liability.*

The court of appeals also expressed apprehension that the imposition of Section 16(b) liability upon the "unsuccessful" tenderor, such as Occidental, would "discourage the making of such offers" (13A). Assuming this to be a proper subject of concern, it would seem, however, likely to discourage only those tender offers made primarily with a manipulative objective in mind. The vast majority of *bona fide* tender offers are made with a view to securing ultimate control of the target company, not a quick profit. On the other hand, some tender offers are undoubtedly made with a view to driving up the price of the stock and realizing manipulative profits. As the then Chairman of the Securities and Exchange Commission testified in hearings before the House Committee on Interstate and Foreign Commerce, 90th Cong., 2d Sess. (on H.R. 14475 and S. 510, at p. 22, July 1, 1968):

> "There has been enough experience in the past 2 years for any sophisticated takeover bidder to know that, unless management joins him, management will seek another partner and that other partner probably will make a slightly better offer. We have the

* In Section 16(b) actions, courts have consistently refused to entertain defenses of an equitable nature, such as unclean hands and estoppel. See *e.g., Magida* v. *Continental Can Co.*, 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956); *Allied Artists Pictures Corp.* v. *Giroux*, 312 F.Supp. 450 (S.D.N.Y. 1970); *Newmark* v. *RKO General, Inc.*, 294 F.Supp. 358, 367 (S.D.N.Y. 1968); *Volk* v. *Zlotoff*, 285 F.Supp. 650, 655-56 (S.D.N.Y. 1968); *Marquette Cement Mfg. Co.* v. *Andreas*, 239 F.Supp. 962 (S.D.N.Y. 1965); *Jefferson Lake Sulphur Co.* v. *Walet*, 104 F.Supp. 20 (E.D.La. 1952), *aff'd*, 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953). On the basis of such authority, the district court dismissed Occidental's affirmative defenses and counterclaims (23C).

> feeling that many of these people are doing it for the short-term gain, or, to use the vernacular, to make a fast buck. We have a number of variants of that. We have a sitution where almost overnight [a] particular individual or company made several millions of dollars in a situation of this kind.
>
> "We have the feeling that some of these offers are made only to initiate that activity."

In giving the above testimony, the Chairman could well have had Occidental in mind. As an article on tender offers, in the August 1967 issue of *Fortune*, states:

> "[W]hile Occidental failed to win control of Kern, it could look forward to a gross capital gain of more than $17 million on the Kern shares it had acquired. 'That', Armand Hammer [Occidental's President] observes, 'isn't bad for two weeks' work'." (p. 109)

While there may be other remedies to deal with the problem of speculative tender offers, it does not follow that Section 16(b) should be denied any role. Given the "prophylactic" remedy embodied in Section 16(b), *Blau* v. *Lehman*, 368 U. S. 403, 414 (1962), imposition of such liability would seem well designed to curb such offers.

Instead of addressing itself to such considerations, the court of appeals took it for granted that the losing contestant in a take-over effort cannot possibly reap a speculative profit, drawing upon particular facets of the Occidental tender offer. Such an *ad hoc* approach (apart from encouraging insiders to litigate each case) ignores the possibilities for speculative abuse inherent in any situation where two companies propose to merge and a large recently-acquired dissident block of stock is outstanding in one of them. Aside from his ability to affect the terms and conditions of the merger itself, the insider holding such a block can use his stock position to make a profitable

arrangement, not available to other shareholders, for himself. This is exactly what Occidental did here in carrying forward its threats of a proxy fight, supported by legal demands and litigation (which enabled it to secure an extensive inspection of Old Kern's non-public books and records), until it was able to secure a special (and very profitable) arrangement for itself in the form of the Option Agreement.

Apart from its refusal to promulgate an exemptive rule on Occidental's behalf, the Securities and Exchange Commission has also taken a position contrary to that adopted in the opinion below. In 1964, the Special Committee on Securities Regulation of the Association of the Bar of the City of New York proposed to the Commission that it adopt a rule excluding exchanges of stock resulting from mergers and corporate acquisitions from the operation of Section 16(b).* In rejecting such proposal by letter dated November 24, 1965, the Commission wrote to the Committee as follows:

> "The Commission has also determined, as recommended by the staff, not to propose any revision in the liability provision of the section as it applies to the transactions of exchange involved in mergers, consolidations, recapitalizations and reorganizations. Our recommendation was based on our belief that there are distinct opportunities to profit from the use of inside information during the period of time surrounding such significant corporate events and that *profits must be deemed 'realized' at the time of exchange if the purposes of Section 16(b) are to be carried out.* This belief is supported by the legislative history of Section 16, court opinions and past Commission statements. We concluded, therefore, that these transactions were encompassed within the purpose of Section 16(b) which, as you know, is to prevent the unfair use of inside information. . . .

* One of petitioner's counsel, whose name appears on this brief, was a member of such committee.

> "We recognize that under certain circumstances, Section 16(b) does create a conflict of interest for an insider who stands to lose profits if a merger, consolidation, recapitalization, or reorganization is not delayed. We concluded, however, that removing the 'teeth' of Section 16(b) to discourage the use of inside information would allow insiders to create and take advantage of speculative opportunities during the time surrounding such significant corporate events which outweighed this potential conflict. Also, *we know that some persons are unwittingly caught by the section in these as in other situations falling within the provisions of Section 16(b), but in our opinion the public interest and the interest of investors are better served in this area by the unrestricted operation of the section.*" (Emphasis added)

Now, the Court of Appeals for the Second Circuit has adopted a judicial rule with respect to exchanges of securities which does, insofar as tender offerors are concerned, what the Commission refused to do in 1965 and which is, ironically, far broader than the limited rule with respect to tender offerors which the Commission refused to adopt at Occidental's behest in 1967.

The court of appeals' treatment of the exchange of securities thus raises a question of general importance to the future application of Section 16(b): Whether the courts may grant *ad hoc* exemptions from Section 16(b) in cases involving so-called "unusual" transactions as opposed to the "garden variety" cash purchase or sale, particularly where, as here, the Securities and Exchange Commission has not seen fit to adopt an exemptive rule. Aside from a few exceptions set forth in the statute, Section 16(b) mandates recovery from an insider of "any profit realized" through the purchase and sale of equity securities of the relevant issuer within a six-month period, but provides that it shall not apply to "any transaction or transac-

tions which the Commission by rules and regulations may exempt as not comprehended within the purpose" of Section 16(b). The statute clearly imposes a broad objective standard of liability, reserving to the Commission through rule-making proceedings of a legislative nature, and not to the courts in individual cases, the power to define types of transactions which should be exempt. The statutory scheme thus provides the possibility of relief for persons deserving it in "situations that Congress scarcely considered" (9A) without undermining the "mechanical quality" of the statute by encouraging every insider to resist recovery and litigate in the hope of persuading a court, as here, that it would be "repugnant" to its "sense of equity" (13A) on the facts of the particular case to require recovery of profit realized in a non-cash transaction.*

Indeed, the Commission has in fact adopted rules exempting certain non-cash exchanges of securities in mergers and other exchanges from the operation of Section 16(b). Rule 16b-6 exempts such transactions when the purchase has occurred by exercise of an option acquired more than six months prior thereto, thereby allowing corporate officers who hold stock options which may be exercisable at well below the then market price and which might be lost as a result of the merger to exercise their options without having the merger itself (which would otherwise be a

* One member of this Court has written with respect to Section 16(b):

> "[I]f the Congress intended to provide additional exceptions, it would have done so in clear language; . . . the recognized purpose and aim of the statute are more consistently and protectively to be served if the statute is construed literally and objectively rather than non-literally and subjectively on a case-by-case application. The latter inevitably is a weakening process." *Petteys* v. *Butler*, 367 F.2d 528, 538 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967) (Blackmun J., dissenting).

"sale" of their stock) result in their losing the benefits of the option by reason of Section 16(b). Rule 16b-7 exempts "[t]he disposition of a security, pursuant to a merger or consolidation, in exchange for a security of a company which, prior to said merger or consolidation, held over 85 per cent or more of the equity securities of all other companies involved in the merger or consolidation" or "held over 85 per cent of the combined assets of the companies undergoing merger or consolidation", thereby excluding what are essentially intra-corporate reorganizations involving no change in beneficial ownership.

Here, as noted above, the court of appeals in effect promulgated a rule with respect to tender offerors far broader than the rule which was proposed to the Commission by Occidental and which the Commission expressly refused to promulgate.

Several courts have, of course, concluded that, considered in the light of the purpose of Section 16(b), certain types of transactions, "objectively defined", should not be considered to be "purchases" or "sales" within the meaning of Section 16(b). However, these decisions have been premised upon the conclusion that there was no possibility of speculative abuse where the transaction did not involve a real change in the equity investment of the insider (which in fact was maintained for more than six months)* or where the transaction was one which did not result in a profit.** These decisions do not, as the opinion below suggests (9A), con-

* See, *e.g.*, *Ferraiolo* v. *Newman*, *supra*; *Blau* v. *Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967) and *Petteys* v. *Butler*, *supra* (conversion of convertible security); *Blau* v. *Mission Corp.*, *supra* (transfer to 100%-owned subsidiary); *Blau* v. *Max Factor & Co.*, 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965) (exchange of substantially identical classes of equity security).

** See, *e.g.*, *Shaw* v. *Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949) (private gift).

stitute a "revolt" against the objective character of Section 16(b), but are simply determinations that, in situations of the type considered, a basic element of liability was absent, *i.e.*, either an investment of less than six-months' duration in the issuer or realization of a profit, and that therefore the "transaction" was not one susceptible of "speculative abuse", *i.e.*, the realization of short-term profits by insiders, which Section 16(b) is designed to prevent. None of these decisions suggest that each case should be treated on an *ad hoc* basis; rather, they deal with *types* of transactions which they conclude cannot possibly result, *regardless of the facts of any particular case,* in the kind of abuse at which the statute is aimed.

Unlike the conversion cases noted above, where the courts were able to find that the intra-corporate exchange, standing by itself, presented no possibility of speculative abuse, the court of appeals here did not hold that an exchange of stock of one company for that of a totally different company, standing by itself, could not lend itself to speculative abuse, but instead asserted that the particular facts before it, starting with Occidental's acquisition of its shares in a tender offer, showed no evidence of speculative abuse on the part of Occidental. Indeed, Occidental's brief in opposition to the petition for certiorari acknowledged that the test of Section 16(b) liability applied by the court of appeals here was one which "requires a careful examination of the facts . . . on a case by case basis" and that "[a] decision on the facts of this case cannot resolve future merger cases . . ." (Br., p. 3). Only by undertaking such an *ad hoc* examination of Occidental's situation (and by accepting without trial Occidental's protestations of innocence) was the court of appeals able to conclude, for the first time, that an exchange of securities of one company for those of a totally separate and distinct company was not a "sale" for purposes of Section 16(b).

In contrast to its holding here, the Court of Appeals for the Second Circuit had shortly before expressly held (as

this Court noted in its *Reliance* opinion) that "an exchange of shares in one corporation for those of another pursuant to a merger agreement constitutes a 'sale' within the meaning of § 16(b)". *Reliance Electric Co.* v. *Emerson Electric Co., supra,* 404 U. S. 420, n. 2, citing *Newmark* v. *RKO General, Inc.,* 425 F.2d 348, 354 (2d Cir.), *cert. denied,* 400 U. S. 854 (1970). In its opinion here, the court of appeals described the *Newmark* opinion as merely having held that "an exchange pursuant to a merger *may be* a 'sale'" (emphasis the court's) and confined the holding in that case to "the particular exchange there a issue" (11A).

At least one district court in the Second Circuit did not read *Newmark* v. *RKO General, Inc.* so narrowly. In *American Standard, Inc.* v *Crane Co.,* CCH Fed. Sec. L. Rep. ¶ 93,237 (S.D.N.Y. 1971), a case involving the basic elements presented here—(a) an attempted take-over by purchase of stock, including a tender offer, (b) opposition of the target company, followed by (c) a merger between the target company and a different partner—the district court found that the exchange of shares occurring by reason of the merger was a "sale" under the *Newmark* case, stating:

> "It is true that the Court—properly—placed emphasis on the facts that RKO controlled Frontier, had knowledge of the merger, and had a contract right to cancel the agreement, and that its option to purchase Central securities at a fixed price put it in ideal position to profit from an anticipated rise in the price of the stock—facts not present in the instant case. However, exceptional as such facts are, at least in combination, they were not elements sine qua non to the finding. Rather they merely underpinned, although emphatically, the opportunity for speculative abuse which there existed."

The foregoing opinion was filed on October 12, 1971, the day before the court of appeals' decision here. Two days later, the district court withdrew its opinion in light of the decision below.

Petitioner respectfully submits that the holding of the *Newmark* case, as it was interpreted by the district court in *American Standard, Inc.* v. *Crane Co., supra,* and by this Court in *Reliance Electric Co.* v. *Emerson Electric Co., supra, i.e.,* that "an exchange of shares in one corporation for those of another pursuant to a merger agreement constitutes a 'sale' within the meaning of § 16(b)" (404 U.S. at 420 fn.), sets forth the correct rule of law.

CONCLUSION

For the reasons set forth above, the judgment of the Court of Appeals for the Second Circuit should be reversed.

Respectfully submitted,

DAVID R. HYDE,
Attorney for Petitioner,
80 Pine Street,
New York, New York 10005

Of Counsel:

CAHILL, GORDON, SONNETT,
REINDEL & OHL
F. ARNOLD DAUM
WILLIAM E. HEGARTY
IMMANUEL KOHN
80 Pine Street
New York, New York 10005

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